CHAPTER

9

# The Unification of Germany and the Unification of Europe

*The particularism of the stocks, dynasties, and cities, the dualisms of west and east, of Protestants and Catholics, of Lutherans and Reformed, of Prussia and Austria, of imperial patriotism and colonial expansion eastward, of mysticism and scholasticism, of rationalism and faith, of nobility and bourgeoisie, of civilian and military, of bureaucracy and public opinion, of capitalism and labor—all these tensions in German history needed to be resolved. The attempt would be made at first in a provisional way by claim to supremacy put forward as a missionary concept; only after such an effort failed would compromise be tried.*

—Veit Valentin, *The German People: Their History and Civilization from the Holy Roman Empire to the Third Reich* (New York, Alfred A. Knopf)

## Introduction

The problem of Germany is the problem of Europe: Can unity be created from diversity while respecting diversity? For over a thousand years the much-divided Germans have struggled to create unity, but each time they succeeded they overreached themselves by attempting to absorb their neighbors in a universal empire. The same question haunts Europe: Does the unification of West and East Germany mean that there will be "a European Germany or a German Europe"?

An economic manifestation of this problem is the weakening of the European exchange rate mechanism (ERM),[1] due to high German interest rates

[1]Currencies in the ERM stay within a band with respect to each other in value. In September 1992 the United Kingdom and Italy dropped out after experiencing speculative attacks, and the Spanish peseta was devalued while remaining within the system. In August 1993 the band was widened from 2½ percent to 15 percent after speculative attacks against the French franc and the Danish krone. The ERM is the centerpiece of the European monetary system (EMS), which members agreed at Maastricht in 1991 would be a halfway house to a single currency, the European currency unit (ecu).

brought on by high budget deficits arising from the costs of German unification. Despite lowering rates, the German central bankers refuse to bend their monetary policy for European unity and forced devaluations of other currencies in the ERM. The unification of Germany makes it harder to unify Europe and makes it more likely that a unified Europe will be a German Europe rather than a European Germany.

German GDP is the world's fourth largest and one of the highest per capita. Drawing on a highly educated and hardworking population, Germany industrialized rapidly in the late 19th century after its unification in 1871 by the Iron Chancellor, Otto von Bismarck. This fed ambitions underlying Germany's aggressive role in World Wars I and II.

Germany's overwhelming defeat in World War II brought a collapse of its economy and division into the Federal Republic of Germany (FRG) in the West, which adopted a market capitalist economic system, and the German Democratic Republic (GDR) in the East, which adopted a command socialist economic system.[2] These two competed vigorously in the Cold War, both growing more rapidly than most economies of their respective systems. But the FRG's growth outstripped the GDR's. After freeing prices and introducing a new currency in 1948, FRG economic performance was labeled the *economic miracle* (*Wirtschaftswunder*). In 1990 the GDR ceased to exist and joined the FRG as a broken-up set of Länder (provinces).

Today Germany has the archetypal *social market economy*, a term invented in postwar West Germany. It respects private property and market forces, eschewing central planning.[3] But it has an extensive social safety net and income redistribution system. In the 1880s, Bismarck established the world's first government-run health insurance, social security, and workmen's compensation systems.[4]

Comparing the German economy to Sweden's, also a social market economy as described in the previous chapter, Germany's social welfare system is not as extensive, nor are its taxes as high or as progressive. Germany does not use active labor policies, but its apprenticeship system produces a highly skilled blue-collar labor force.[5] It does not have corporatist centralized wage bargaining, but it has *co-determination* (*Mitbestimmung*) in which works

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[2]There was more division because former German territories in the East were annexed by the USSR and Poland. The FRG only gave up its demand for those territories in 1990 under pressure from the international community to gain acceptance of its unification with the GDR.

[3]Between 1967 and 1972 a half-hearted effort at "Concerted Action" occurred—major economic actors discussed trends and policies in an imitation of French concertation with hints of Swedish corporatist bargaining.

[4]The main supporter of such legislation at the time, the German Social Democratic Party, was outlawed. Bismarck co-opted its policies while suppressing it.

[5]In contrast to Sweden's, Germany's apprenticeship system reduces labor mobility by its specialized training. It directly descends from the medieval guild system with its masters, journeymen, and apprentices.

councils advise management and labor leaders sit on supervisory boards of corporations, bringing about considerable labor-management cooperation.

Compared to most countries, including Japan, Germany has a strong banking sector that dominates the economy and owns large portions of stock in major corporations. During the late 19th century the banks encouraged protectionism and cartelization of industry, which lasted until the end of World War II. This bank domination has persisted in the postwar decartelized free trade economy.

Furthermore, the central bank (Bundesbank) is, along with Switzerland's, the most independent from political influence in the world. It executes a rigorous monetarist policy, which gives Germany consistently low inflation.[6] The Germans are suspicious of giving up their strong deutsche mark and sound money policies for a probably weaker ecu and looser "Eurofed,"[7] and thus they have cracked the ERM with their strict policies.

Despite its successes, Germany recently dragged the EU into a serious recession from which both are now emerging. But two other elements with long-term implications lead observers to discuss Germany's "fading miracle."

One is a long-term slowdown of growth greater than the general global slowdown that has occurred. This slowdown has been accompanied by a long-term increase in unemployment and outbreaks of neo-Nazi skinhead violence directed at foreigners. German growth has long been led by exports of technologically advanced engineering products, with Germany at times being the world's top exporter. But now Germany faces increasingly stiff competition, especially from Asian producers, and many wonder if it is losing its edge.

The other problem is that unification with the former GDR is costlier and more difficult than anyone predicted. FRG Chancellor Helmut Kohl had forecast that the outcome would resemble the Wirtschaftswunder in West Germany after 1948. But the 1990 East German economy was further from market capitalism than the 1948 West German one; there was private ownership of the means of production in the 1948 West but there was not in the 1990 East. Also the productivity, quality, and environmental differences between the economies were much greater than had been thought.

Combined with the collapse of the entire European socialist bloc and the sharp contraction of markets for East German goods in the former Council on Mutual Economic Assistance (CMEA)[8] countries was a massive collapse of output in eastern Germany. This led to greater expenditures on unemployment

[6]This policy reflects memories of the 1923 German hyperinflation, which undermined the interwar Weimar Rupublic and paved the way for Hitler. Anti-inflationary policy was aided until recently by modest union wage demands.

[7]The European Monetary Institute formally opened in 1994. It provides the institutional nucleus for a future EU central bank.

[8]The CMEA, or COMECON, was the trade organization of the part of the socialist bloc dominated by the former Soviet Union.

compensation and privatization efforts by the FRG government than expected. The resulting budget deficits[9] led the Bundesbank to raise interest rates, bringing about the general European recession and the ERM-cracking currency crises.

The process of privatizing and integrating the former GDR economy has gone far and as of 1994 output was increasing again. But deep differences remain between East and West with rising resentments between *Ossis* (East Germans) and *Wessis* (West Germans), the former complaining of domination by the latter and the latter complaining of excessive expenses to support the allegedly lazy former. Eastern unhappiness is symbolized by the reappearance in the Reichstag (parliament) in 1994 of the former Communists, now the Party of Democratic Socialism.

## Historical Background of the German Economy

### *The Origins of the "German Problem"*

The Romans called them *Germani,* although their own identity then was tribal, and there were many tribes.[10] Blocking European unity in 9 A.D. by defeating an invading Roman army, they would conquer that empire four centuries later.

In 800 the Frankish leader Charlemagne attempted to create a universal unified European state, the Holy Roman Empire.[11] For the next thousand years, there would be a Holy Roman Emperor, a German pretending to rule a universal Christian state in Europe.

Here was the "German Problem" for Europe. There really was no Germany—it consisted of tribal entities with ill-defined borders. Germany sought to rule Europe,[12] but its own power was in the hands of local dukes, archbishops, princes, and the like. Only with the 1871 Bismarckian unification would there be a Deutsches Reich (German Kingdom).[13]

Because of being a trade route in Central Europe and a center of innovations symbolized by Gutenberg's invention of the printing press, the German economy experienced substantial growth in the 1400s and 1500s. But it was shattered by a disaster, the Thirty Years War (1618–1648), the ultimate

[9]Chancellor Kohl had promised there would be no tax increases.

[10]The most prominent core German tribes were the Saxons, Bavarians, Franks, Allemani (later called Swabians), Thuringians, and Frisians. Several of these provided the names for modern German Länder (Saxony, Bavaria, Thuringia).

[11]In the 1700s Voltaire quipped that it was neither holy, Roman, nor an empire.

[12]This effort involved a conquest movement eastward into Slavic lands, creating Austria and later Prussia, whose militaristic and authoritarian *Junker* aristocracy brutally enserfed the Slavic peasants and would later unify Germany.

[13]Modern Germany is an artificial creation out of still-disparate tribes. There are substantial differences between the German spoken in different regions, and the northern Germans from Hamburg are more physically similar to the southeastern English than to Latinized southern or Slavicized eastern Germans.

European showdown between Protestantism and Catholicism. It left Germany divided religiously, a third of its population killed, and its economy ruined.

## *The Rise and Fall of Imperial Germany*

In 1871 Prussia's Chancellor Bismarck overcame tribal separatism to unify Germany[14] by getting the tribes to join in the successful Franco-Prussian War. Prussia led the unified German Empire partly because it had experienced the most economic growth, including nascent industrialization.

The German economy expanded and industrialized rapidly after 1871. Between then and 1913, just before World War I, exports more than quadrupled and steel production surged past Great Britain's, leading to intense commercial competition with Britain that drove their diplomatic and military rivalry. The British overcame their ancient antipathy towards the French to ally against Germany. Their victory over Germany in World War I led to the replacement of the empire with a republic.

A feature of German growth was its lead in general science and technology prior to industrialization.[15] One area with early economic payoff was the chemical industry, which Germany led after organic chemistry studies of scientifically applying fertilizer in the 1840s. In the 1880s, Otto Benz invented the first true automobile and founded Daimler-Benz, producer of high-quality Mercedes-Benz cars. High-technology export goods remain a key feature of German economic success. This feature is reinforced by the fact that more German managers possess engineering backgrounds than do managers in other countries.

## *The Weimar Republic and the Nazi Command Capitalist Economy*

In November 1918, the Social Democrats took control of the government and established the Weimar Republic. Signing the surrender and the 1919 Versailles Treaty, which took territory from Germany and imposed massive reparations payments, alienated nationalists. They would eventually follow

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[14]Of the states joining the German Empire, the most reluctant was the Kingdom of Bavaria in southeastern Germany, which harbored serious separatist movements well into the 20th century. It was one of the larger old German states and resented Prussian domination partly for religious reasons as a Catholic state, northeastern Prussia being Protestant. The Bavarians have their own political party, the Christian Social Union, which allies with the Christian Democrats but is more conservative.

The unification did not solve the German Problem because there were many ethnic Germans outside the empire in Switzerland, Austria, and elsewhere, and many non-Germans, especially Poles, within it. These issues stimulated the expansionism of Germany in the two world wars.

[15]Germany lost its scientific leadership to the United States in the 1930s when Hitler's persecution of Jews and other groups caused a migration of top scientists to the United States. The most famous was Albert Einstein, who convinced President Roosevelt in 1938 to authorize the Manhattan Project that built the atomic bomb. Many of the Manhattan Project's participants were also refugees from Germany.

**Box 9–1**

## The German Hyperinflation

Hyperinflation is shown in the following table, which shows the exchange rate of the mark to the U.S. dollar from 1914 until November 1923. Although the economy stabilized after this until the Great Depression struck in 1929, the hyperinflation deeply discredited the Weimar Republic. Many people saw their life savings wiped out in a very short space of time and became open to the idea of searching for a scapegoat. At the end of the hyperinflation, people had to take wheelbarrows full of money just to do their grocery shopping.

**Marks per U.S. Dollar, 1914, 1919–1923**

| *Dates* | *Value* |
|---|---|
| July 1914 | 4.2 |
| July 1919 | 14.0 |
| July 1921 | 76.7 |
| July 1922 | 493.2 |
| January 1923 | 17,972.0 |
| July 1923 | 353,412.0 |
| August 1923 | 4,620,455.0 |
| September 1923 | 98,860,000.0 |
| October 1923 | 25,260,208,000.0 |
| November 15 1923 | 4,200,000,000,000.0 |

Note: The figures are monthly averages.
Source: From Gustav Stolper, Karl Häuser, and Knut Borchardt, *The German Economy: 1870 to the Present* (New York: Harcourt, Brace & World, 1967), p. 83.

the National Socialist (Nazi) leader, Adolf Hitler, who argued that these acts resulted from an "international Jewish conspiracy."

Besides reducing military spending, removing agricultural tariffs, and introducing Workers' Councils to advise managements in the workplace,[16] the economic policies of the Social Democrats differed little from prewar ones. Its policy making was overwhelmed by the reparations payments announced in 1921. Payment difficulties stimulated hyperinflation, which accelerated until a new currency and reform program were implemented in November 1923, relying upon U.S. loans.

The Great Depression hit Germany harder than any country. At its pit in 1932 the Nazis became the largest party in the Reichstag. In January 1933

[16]These councils presaged the modern co-determination system, but they were largely ineffectual.

Hitler was appointed Chancellor. He soon outlawed all other parties, seized absolute power as Fuhrer, and declared the Third Reich. In 1939 his invasion of Poland began World War II in Europe. Hitler oversaw the Holocaust, in which six million Jews and millions of other people were killed. In 1945, faced with German defeat, Hitler committed suicide.

Hitler imposed a command capitalist economic system that achieved economic growth until it was distorted by war.[17] For Hitler, economic ideology and practice were subordinated to his anti-Semitic and militaristic nationalist politics. In the early 1920s the National Socialist German Workers' Party (the Nazi Party's full name) had an anticapitalist bias, opposing interest and land rent and calling for nationalizing many businesses. But Hitler was anti-Communist and appealed to small and big business for support.[18] In 1929 the official party line supported a "corporate state." In practice Hitler did not nationalize industries and purged the socialist wing of the Nazi Party shortly after his seizure of power.

The focus of Hitler's economic program was to build up the military as rapidly as possible and as independently from other nations as possible. He imposed price controls and compulsory cartelization and outlawed independent labor unions. The government controlled foreign trade and foreign exchange transactions, made bilateral deals with countries southeast of Germany, and emphasized self-sufficiency. Economic sectors were organized in "chambers" that followed government orders. Early in Hitler's rule, he emphasized infrastructure investment, such as constructing highways (autobahns).

Prior to the war Hitler's economic policies were quite successful. Germany came out of the Depression rapidly—its GDP doubled between 1932 and 1938, and the unemployment rate fell from 29.9 in 1932 to 0.5 in 1939 when the war began. But the economy had already hit bottom and begun to grow in 1932 prior to Hitler's ascension to power.

# A Tale of Two Postwar German Economies

## *The West German Wirtschaftswunder and Its Fading*

**The Partition and the Miracle.** Germany surrendered on May 9, 1945, and was partitioned into six zones. Two were annexed respectively by Poland and the Soviet Union and experienced massive out-migrations to western parts of Germany. What is today Germany was split into four zones of occupation by France near its border in the southwest, by the United Kingdom in the north, by the United States in the south, and by the USSR in the east. Berlin was a

[17]Although Germany had a 0.5 percent unemployment rate in 1939, between then and 1944 armaments production nearly quadrupled. Slave labor from conquered territories was used.

[18]Hitler's compulsory cartelization policy weakened small businesses. Most big businesses initially supported Hitler unenthusiastically. But, it was a widespread postwar consensus that Hitler was put in power by the big cartels, some of which were then broken up.

special area, which was also subdivided into four zones of occupation. In 1947 the U.S. and U.K. zones were united in "Bizonia," to the initial opposition of the French and Soviets. The deepening Cold War and Marshall Plan aid led the French to let their zone join in the newly declared Federal Republic of Germany (FRG) in 1949, and the Soviet zone became the newly declared German Democratic Republic (GDR) that same year.

The German economy of 1946 had experienced a massive collapse. Compared to 1939 national income was less than half, industrial production less than a quarter, rail freight a third, and food consumption barely above half.[19] This was a horrible situation, but one that offered the possibility of future rapid growth through rebound. But how to achieve rebound? At first there was no interest in achieving it in the Soviet zone, but there was in the American and British zones from 1947.

The capital stock of West Germany was actually higher in 1946 by 16 percent than it was in 1938 and only limited reductions had occurred in the labor force.[20] But, there were three problems: First, destruction of transportation and communications infrastructure created production bottlenecks. Second, huge portions of capital stock had been diverted to military production, which had ceased. Third, economic paralysis resulted from fixed prices, rationing, and monetary overhang[21] left over from Hitler's economic system. The first problem was readily remedied by 1947 through sectorally concentrated capital investment.

In January 1948 Ludwig Erhard became Administrative Director of the Bizonal Economic Administration and sought to resolve the other two problems. He was associated with economists based at Freiburg University known as *Ordo-liberals.* They strongly supported free markets and private property. But they also wanted a state strong enough to break up cartels, which they blamed for the Nazi episode.[22] They also supported government provision of a social safety net, hence the "social market economy."

Erhard's first move came in March 1948 when he established a central bank. It was built up out of state banks created in the Länder by the Allies, and its governing board was dominated by the presidents of the Länder banks.[23] This governing board remains the basis of control of the Bundesbank and its policy-making independence.

[19]Gustav Stolper, Karl Häuser, and Knut Borchardt, *The German Economy: 1870 to the Present,* trans. T. Stolder (New York: Harcourt, Brace & World, 1967), p. 205.

[20]Holger C. Wolf, "Postwar Germany in the European Context: Domestic and External Determinants of Growth," ED–93–11 (Stern Business School, New York University, 1993) pp. 3–4.

[21]*Monetary overhang* arises in a goods economy when there is much money in circulation but goods are in short supply and prices are fixed.

[22]Some firms were broken up, most prominently the chemical giant, I. G. Farben, which became Bayer, Hoechst, and BASF.

[23]An important characteristic of the FRG was already manifest, its high degree of decentralization with many social and economic policy-making powers in the hands of the Länder. In this way the FRG has achieved its own resolution of the long-running conflict between the tribes and national unity.

On June 20, 1948, without prior notice, a new currency, the deutsche mark, replaced the old Reichsmark at a 1-to-1 ratio for current wages and prices, but at a 1-to-10 ratio for all debts, thereby wiping out monetary overhang at one stroke. A few days later Erhard removed price and rationing controls on all but a few essential foods plus coal, steel, and electric power, while retaining foreign exchange controls that remained in place until 1958. The result was the immediate appearance of previously hoarded goods on shelves and an increase in industrial production of 50 percent in 1948 and of 25 percent in 1949.[24] This began the *Wirtschaftswunder,* the West German economic miracle. Its success made it the model for reform of the East German economy and it is the prime inspiration for all "Big Bang" (everything-all-at-once) reform programs throughout Eastern Europe.[25]

After some initial stumbles,[26] the Wirtschaftswunder continued strongly during the 1950s, led by a tripling of exports between 1950 and 1958 and a growth rate of industrial production between 1950 and 1955 greater than any nation in Europe. The FRG's acceptance into various international economic bodies, especially the European Coal and Steel Community, enhanced exports. Although West Germany received $4.5 billion worth of Marshall Plan aid, that figure was a lower percentage relative to the economy than in many other European recipient countries. Possibly the real significance for the FRG of the Marshall Plan was its support for establishing the trading system in Western Europe and for integrating the FRG into that system.

**The Fading Miracle.** Because the Wirtschaftswunder was so dramatic, the slowdown of growth later also seemed dramatic. 1955 was the last year the FRG had a double-digit real growth rate (12 percent). It surged to 9 percent in 1960 after the final currency decontrols and hit 8.2 percent in 1969, but it has not come close to such rates since.[27] Annual rates of increase in productivity have steadily declined from a 5.1 percent average over 1951–64, to 4.4 percent over 1964–73, to 2.9 percent over 1973–79, to 1.5 percent over 1979–87.[28] Why has the miracle faded?

One school of thought says the slower growth rate was an unavoidable consequence of combining a generally declining world economic growth rate with the fact that the FRG had "caught up." The latter part is supported by the very strength of the rebound effect in the late 1940s and early 1950s.

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[24]Stolper, Häuser, and Borchard, *The German Economy,* p. 231.

[25]It played a role in finalizing the split between East and West Germany, formalized in 1949. The Soviets refused to allow such a blatantly market capitalist approach in the East.

[26]Despite current fond memories, the public initially was slow to accept that it was beneficial. Unemployment rates continued to rise through 1950. It was not until 1954 that more West Germans said they perceived an improvement rather than a worsening in living standards (Wolf, "Postwar Germany in the European Context," p. 25).

[27]V.R. Berghahn, *Modern Germany: Society, Economics and Politics in the Twentieth Century* (Cambridge: Cambridge University Press, 1982), p. 262.

[28]W.R. Smyser, *The Economy of United Germany: Colossus at the Crossroads* (New York: St. Martin's Press, 1992), p. 28.

An alternative response is a German variant of *Eurosclerosis,* a theory popular with the Ordo-liberals. All of the EU has slowed down. Since the 1970s the EU has had persistently high unemployment rates compared with the United States and Japan. The Eurosclerosis view argues that this slowdown is due to restrictive labor market practices and other regulations inhibiting the market economy that have grown up over time.

In the FRG unemployment rates averaged 0.9 percent over 1960–64,[29] 1.2 percent over 1965–69, 1.3 percent over 1970–74, 4.4 percent over 1975–79, 7.0 percent over 1980–84, and 8.8 percent over 1985–89. After a brief decline in 1990 and 1991, they rose again as the FRG went into recession, aggravated by the double-digit unemployment rates in eastern Germany, but they are declining again gradually. Whether these high unemployment rates are due to excessively high wages, restrictive firing rules (as charged by the Eurosclerosis group), or the co-determination system, they aggravate the revival of neo-Nazi activities and skinhead attacks on foreigners.

**Industrial Relations.** Germany has a unique system of labor-management relations that the Eurosclerosis group blames partly for the "fading of the miracle." *Mitbestimmung,* or co-determination, comes in two parts. The first was introduced in 1952 and mandates the establishment of *works councils* in establishments with more than five employees. Elected by workers at a work site, councils are supposed to advise management on day-to-day operations. They do not set prices or output levels or negotiate wages. They deal with working hours, hiring and firing rules (the complaint of the Eurosclerosis group), and technical aspects of production.

The other aspect of co-determination is election of workers to company supervisory boards, made compulsory in 1976 for firms with more than 500 employees. German corporations have two levels of oversight bodies, the supervisory board being above and appointing the more frequently meeting board of directors or management board. The law mandates that shareholders[30] elect two-thirds of the members of the supervisory board while the remaining one-third is split between workers elected by their colleagues and union representatives. Workers themselves take the works councils more seriously than their representation on the supervisory boards.

Both of these systems were designed to bring about peace between labor and management, reducing output lost to strikes, and to moderate wage demands thus helping to reduce inflation. The former goal was largely met and losses due to strikes declined to about one-tenth of what they were in the interwar period,[31] a substantially lower figure than in most other European countries. But there has been a big increase in strikes since the FRG-GDR

[29]This lowest level of unemployment coincided with the cutoff of immigration from the GDR after the building of the Berlin Wall in 1961.

[30]The supervisory boards are stacked with bankers. In 1985 for the 24 largest German firms, the portion of shares held by all banks was 82.67 percent and the portion held by major banks was 45.44 percent (W. R. Smyser, *The Economy of United Germany,* p. 86).

[31]Berghahn, *Modern Germany* pp. 286–7.

unification. Although German labor costs are now the world's highest, inflation had remained low until unification and current account balances had remained in surplus until then as well.

Ordo-liberal critics of these arrangements argue that together they have interfered in the workings of the market. An effort at quasi-corporatist, quasi-indicative planning, "Concerted Action" by the government during the late 1960s and early 1970s symbolized this interference.

Labor unions left Concerted Action after becoming a minority on the supervisory boards, as determined in the 1976 law on co-determination, and they have become increasingly militant. Strike activity increased in 1978, and one strike was directed for the first time at preventing a new technology (in printing) from being adopted, a direct threat to the driving force of German economic growth. More aggressive labor has since pushed such ideas as shorter work weeks, now the shortest in the world. With unification all of these issues have become more intense and labor-management relations have dissolved into general hostility, despite the persistence of the institutions of co-determination.

**The Social Safety Net.** Prior to unification social policies were less of an issue, although the share of GDP for social programs increased at about 10 percent per year during Social Democratic rule in the 1970s, a trend reversed after the party was removed from office in 1982. In the early postwar era the major effort was simply to restore the programs that had existed before Hitler wrecked them, many dating from Bismarck's time. Only in the late 1960s was an effort to expand social programs initiated, starting with a direct child allowance. The FRG also made compensatory payments to victims of Nazi oppression. Upward cost pressure has occurred because of a rising percentage of old people receiving social security and because of rising medical costs. Unemployment compensation costs have risen as unemployment has risen.

The German social safety net is highly decentralized, organized either on industrial lines or locally. Medical coverage is provided by bodies funded by combined payroll-employer payments and are self-financing, although that is not true of old age insurance. This decentralization reflects the relatively decentralized nature of the FRG, in which the Länder have considerable power. The issue of the social safety net has become highly controversial since the FRG-GDR unification—costs for such programs have soared in the East and cuts have been made in the West.

## *The Development of the East German Command Socialist Economy*

East Germany, the German Democratic Republic, was one of only two areas in the world (the other being the Czech Republic) that came to have a Marxist-oriented regime after having achieved industrialization. In contrast to Marx's forecast it was an external force, the Soviet military, that imposed the regime on the society after the German surrender in 1945.

The group of men, led by Walter Ulbricht, who led the GDR in its early years came from a minuscule fragment of the pre-Hitler Communist Party of Germany, which was proudly descended from the Spartacus League of 1919 and from Marx and Engels themselves.[32] After Hitler came to power many party members were arrested and executed, others gave up and converted to National Socialism, and others escaped westward, thus becoming considered unreliable. Among those who went to the Soviet Union, many died in the Great Purges of the late 1930s, some allegedly due to Ulbricht's own orders. Thus it was only a remnant that was left to take power after the Soviet army conquered Berlin.

Although the area of the GDR was slightly ahead of that of the FRG in per capita output in 1939, it fell behind immediately in the postwar period. The USSR carted off wholesale entire factories, livestock, timber, machinery and equipment, and railroad rolling stock in large quantities, both as reparations and to help rebuild the Soviet economy. This policy continued until August 1953, when a major uprising by workers protesting their wages and living conditions brought an end to it in the immediate post-Stalin period. Thus after 1947, while the United States was building up West Germany with Marshall Plan aid,[33] the USSR was pushing East Germany down. The huge gap that opened up was never overcome, despite strenuous efforts by the East Germans.

Prior to its absorption by the FRG, the GDR had a reputation for being the most efficient command socialist economy with the highest income, as well as one of the most rigidly and tightly controlled. Only some elements of these generalizations were true. A difficulty in discussing the GDR economy is that statistics were frequently falsified. For example, estimates from different sources of GDR per capita output as a percentage of that in the FRG for the 1980s ranged from below 40 percent to over 100 percent.[34]

After forming in 1949, the GDR only slowly adopted the command socialist system. Up to 1953 the Soviet leadership was uncertain whether it wanted to develop the GDR at all or just to plunder it and keep it down. The ease of getting to the West before construction of the Berlin Wall in 1961 also

[32]Although born in Trier in the Rhineland, Marx as a young man studied at the University of Berlin and also at Jena, both in eastern Germany. The Spartacus League sprang from the German Social Democratic Party, and both Marx and Engels encouraged the latter's development. In East Germany the Communist Party and the Social Democrats were forcefully united in 1946 into the Socialist Unity Party, under the domination of the Communists, which would rule the GDR without democracy. The West German Social Democratic Party formally abjured Marxism at a conference in 1959 after a particularly poor electoral performance against the Christian Democrats, after decades of de facto revisionism.

[33]The initial U.S. posture towards Germany was hostile as expressed in the Morgenthau Plan and there were some reparations deliveries. An early sign of the coming split was U.S. General Lucius Clay's order on May 27, 1946, to halt such deliveries, paving the way to differential treatment between East and West.

[34]"A Survey of Germany," *The Economist*, May 23, 1992, p. 7.

operated as a constraint on moving too quickly. Thus, although five-year plans were introduced in 1951, the process of nationalization occurred slowly. The initial wave after the war focused on the property of refugees and war criminals and the very largest firms, especially banks and insurance companies. As late as 1955 over a quarter of output was privately produced and as late as 1959 a majority of agricultural acreage was still privately owned.[35]

By the early 1960s most of the economy was nationalized, some of it in the form of partial state ownership, although a small private sector remained, even after another wave of nationalizations in 1972. In 1963 reforms brought prices in line with costs of production, instituted the use of profits as a principal criterion, and allowed managers some autonomy to retain some profits for discretionary usage. None of this accords with the usual image of the GDR economy.[36]

The GDR integrated into the Soviet bloc, becoming a member in good standing of both the CMEA and the Warsaw Pact, the defense group opposed to NATO. Indeed the GDR generally stood for hard-line positions in both foreign and domestic policies within those organizations and eventually exhibited a certain arrogance based on its alleged lead in productivity, as well as its ideological purity as the home of Marx and Engels. Over time it supplied the CMEA with high-technology goods, such as optical equipment and computer chips, thereby reinforcing its image of economic superiority within the bloc.

In 1979 the GDR introduced the most distinctive feature of its economic system, the *Kombinate.* These were 126 centrally directed combines, employing an average of 25,000 workers in some 20 to 40 enterprises related either vertically or horizontally. These Kombinate were subsequently subject to "perfected" steering mechanisms that avoided a focus on gross output, and in the late 1980s they were to carry out technological intensification, the GDR being one of the few command socialist economies to do so.

The Kombinate in a sense revived the sectoral chambers of the Nazi command economy. The two systems differed in their types of ownership, one public, one private. They also differed greatly with respect to income distribution policies, with the GDR having more equal incomes and a well-developed social safety net. Also, the Nazi regime emphasized that women should have children, stay at home, and go to church (*kinder, kuche, kirche*), whereas the GDR had one of the world's highest labor force participation rates by women.

[35]Berghahn, *Modern Germany,* p. 277. Agricultural productivity in the FRG exceeded that in the GDR at unification. But because of economies of scale and high soil quality, if they can be successfully integrated into the market economy the collectivized farms of eastern Germany have the potential to be more productive than the small family farms of western Germany, which survive largely because of massive state subsidies.

[36]That image was partly based on the political repressiveness of the regime, dramatically symbolized by its willingness to shoot people escaping over the Berlin Wall.

Shortly before German reunification came a resurgence of local pride regarding the Prussian past, really an admission that the FRG was far ahead economically. But critics charged that the FRG had become an American colony and had lost its "Germanness" in a sea of international capitalist homogeneity. The political split between the two Germanies reflected traditional attitudes in the two, the Prussian East having a long authoritarian past and the West having long been a center of prodemocratic views.

## *The Two Economies Compared*

**General Observations.** Comparing the economies of the FRG and the GDR was long a favorite sport of comparative economists because the two Germanies had similar cultural and geographical backgrounds but different economic systems, thus allowing the possibility of some sort of controlled experiment comparison.[37] But there are complications with this idea. The two Germanies had very different immediate postwar experiences—the United States aided the FRG where as the USSR suppressed the GDR economically. Also, being smaller, the GDR suffered more from the disruption of internal German trade than did the FRG. Furthermore, the GDR was integrated into the poorer CMEA trade bloc in contrast with the FRG's integration into the EU trade bloc.[38]

Another problem is seriously distorted GDR data. Immediately after unification in 1990, even at the one-to-one currency exchange rate that was implemented, per capita income in the East was only slightly above one-third of that in the West. Nevertheless almost all studies (prior to unification) found the GDR to have been growing consistently more rapidly than the FRG after the mid-1950s. The CIA[39] found 1981 per capita income in the GDR to be 87.6 percent of that in the FRG. Supposedly the GDR led in growth rates through most of the 1980s.[40]

Despite these difficulties generalizations can be made, most of them consistent with stock stories regarding the differences between market capitalism

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[37]See Martin Schnitzer, *East and West Germany: A Comparative Analysis* (New York: Praeger, 1972), and Paul Gregory and Gerd Leptin, "Similar Societies under Differing Economic Systems," *Journal of Comparative Economics* 1 (1977), p. 524.

[38]This is partly misleading. Because it never recognized the separateness of the GDR, the FRG allowed imports from it duty free. Thus the GDR had a back door into the EU because its goods could be re-exported from the FRG to the EU duty free. This led some to call the GDR the EU's "13th member." Previous access to the EU reduced the GDR's gains from unification because it gained little new access to previously unavailable export markets.

[39]Central Intelligence Agency, *Handbook of Economic Statistics* (Washington, USGPO, 1986), pp. 26–27.

[40]After 1987 according to official statistics, West German growth exceeded East German as the entire EU experienced a boom, since ended, whereas the entire CMEA bloc went into a stagnationist crisis. The GDR resisted it better than most of its fellow CMEA members, a fact that hardline GDR leader, Erich Honecker, annoyingly pointed out to his proreform Soviet colleague, Mikhail Gorbachev.

**TABLE 9–1 Consumer Durables Endowments**

| *Goods* | *East* | *West* |
|---|---|---|
| **Percent of population owning** | | |
| Private car | 54 | 96 |
| TV set | 96 | 99 |
| Color TV set | 57 | 95 |
| Telephone | 17 | 99 |
| Refrigerator (without freezer) | 99 | 81 |
| Freezer (with or without refrigerator) | 43 | 75 |
| Washing machine | 99 | 97 |
| **Proportion of** | | |
| Living space built after 1948 | 35 | 70 |
| Units with bath/shower | 82 | 96 |
| Living space per capita (*in square meters*) | 27.6 | 35.5 |

Note: Except for living space per capita all figures are percentages and are for 1989.

Source: From Hans-Werner Sinn, "Macroeconomic Aspects of German Unification," in *Economic Aspects of German Unification: National and International Perspectives*, ed. P.J.J. Welfens (Berlin: Springer Verlag, 1992), p. 126.

and command socialism. In particular, the FRG had greater efficiency, higher general living standards, and broadly superior environmental quality, whereas the GDR had greater macroeconomic stability, including nearly continuous full employment, a greater degree of income equality, and a somewhat more extensive social safety net.

**Efficiency.** After unification, when firms in the two Germanies faced each other in direct competition, those in the West boomed while those in the East collapsed. The sudden discovery that per capita incomes were not almost equal but that those in the East were only one-third of those in the West strongly supports the greater efficiency of the FRG economy, certainly dynamic, if not static efficiency.

Part of this superior efficiency in the FRG is related to an element that was very hard to measure prior to unification, but that was fundamental, namely product quality. Quality was simply much higher for most Western goods, which had been subject to consumer preferences and market competition, than for Eastern goods produced in response to planner's preferences for captive markets.

**General Living Standards.** With respect to broad living standards see Tables 9–1, 9–2, and 9–3. Although people in the FRG were better off in most categories, people in the GDR were better off in certain collectively provided goods, notably public transportation, housing and electricity (which cost less), and day care. However, no accounting for quality differences is made in these

**TABLE 9–2 Cost in Marks of Goods and Services**

| *Goods and Services* | *East* | *West* |
|---|---|---|
| **Food** | | |
| Potatoes | 4.05 | 5.32 |
| Tomatoes | 4.40 | 2.10 |
| Apples | 1.40 | 2.10 |
| Bananas, 500 kg | 18.50 | 4.10 |
| Bratwurst, kg | 11.00 | 9.90 |
| Herring, 200 g | 3.70 | 1.99 |
| Edam cheese, kg | 9.60 | 9.90 |
| Butter, kg | 9.00 | 8.76 |
| Sugar, kg | 1.59 | 1.72 |
| **Clothing** | | |
| Men's coat | 1,600 | 259 |
| Women's dress | 174.50 | 69.50 |
| Men's leather shoes | 119.20 | 34.95 |
| Boy's T-shirt | 30.80 | 10.90 |
| Children's shoes | 41.20 | 37.95 |
| **Consumer Goods** | | |
| Light bulb, 40 watts | 1.50 | 1.90 |
| PKW, Lada Nova, 550 ccm | 24,500 | 10,210 |
| Men's watch, quartz digital | 260 | 25 |
| Child's wagon | 420 | 198 |
| Bedroom furniture | 4,728 | 1,870 |
| Electric range with oven | 815.00 | 389.50 |
| Ladies' bicycle, no attachments | 490 | 289 |
| **Rent and Transportation** | | |
| Month's rent, 2-room apt., no bath | 33 | 190 |
| Consumer electricity, 75 kwh | 7.50 | 29.30 |
| Local streetcar or bus fare | .20 | 1.93 |
| Day nursery, monthly rate | 7 | 140 |
| Air fare to Romania, round trip | 1,196 | 926 |
| Women's permanent | 9.90 | 45.00 |

Source: From Martin Schnitzer, *Comparative Economic Systems*, 5th ed. (Cincinnati: South-Western, 1991), pp. 230–1. Numbers are for 1987.

tables, which tends to favor the FRG. Table 9–1 presents the endowments of various consumer durables in the two states; Table 9–2 shows the costs in marks of various goods and services in the two states, and Table 9–3 shows the time an average person would need to work in order to obtain the good or service.

Price changes facing East Germans during the six months following currency unification with West Germany on July 1, 1990, moved in directions one would expect from the above tables except for rent and energy, which

**TABLE 9–3 Work Time to Purchase Item, Hours and Minutes**

| *Type of Purchase* | *East* | *West* |
|---|---|---|
| Men's shirt | 7.19 | 1.22 |
| Women's pantyhose | 2.40 | 0.12 |
| Children's shoes | 7.21 | 2.35 |
| Color TV | 1,008.56 | 81.34 |
| Washing machine | 491.04 | 59.09 |
| Rail fare, 15 km | 0.27 | 1.46 |
| Dark bread | 0.07 | 0.12 |
| Milk, liter | 0.07 | 0.05 |
| Pork cutlets, 1 kg | 1.47 | 1.01 |
| Coffee, 250 g | 4.20 | 0.21 |

Source: From Martin Schnitzer, *Comparative Economic Systems*, 5th ed. (Cincinnati: South-Western, 1991), p. 232, for 1989.

remained constant because still fixed by the government, for an overall price decline of 1 percent.[41]

## *Environmental Quality*

This may be the area that most favors the FRG. Polls taken in 1988 and 1990 comparing levels of satisfaction of East and West Germans with various aspects of their lives showed the greatest disparity in this area, with Wessis about twice as satisfied as Ossis.[42] In 1985 sulfur dioxide emissions per capita were 7½ times as great in the GDR as in the FRG and nitrogen oxide emissions were about 20 percent greater,[43] the former reflecting the use of dirty lignite coal in the East whereas the latter reflects the higher use of cars in the West than the East. Per capita carbon dioxide emissions were almost twice as great in 1986 in the GDR as in the FRG.

It is difficult to get proper numbers about water pollution because some water flowing through the GDR came from Czechoslovakia and was already polluted. But general trends are clear. In the West, pollution levels in the Rhine

[41]George Akerlof, Andrew K. Rose, Janet L. Yellen, and Helga Hessenius, "East Germany in from the Cold: The Aftermath of Currency Union," *Brookings Papers on Economic Activity*, no. 1 (1991), p. 10.

[42]Detlef Landua, "The Social Aspects of German Reunification," in *The Economics of German Unification*, eds. A. G. Ghaussy and W. Schäfer (London: Routledge, 1993), p. 202. Other areas where Wessis were more satisfied than Ossis were living standards, housing and income, and public safety. Areas where they were almost equally satisfied were home and family life, health care, and education. In no area were Ossis more satisfied than Wessis.

[43]Günter Streibel, "Environmental Protection: Problems and Prospects in East and West Germany," in *Economic Aspects of German Unification*, p. 201.

were cut to about 10 percent of previous levels for several major pollutants between 1971 and 1986 whereas they increased in the major rivers of the East.[44] Another serious problem in the East is abandoned toxic waste dump sites.

In 1988 per capita expenditures on environmental protection were 388 marks in the FRG and 107 marks in the GDR.[45] Since unification a crash environmental cleanup program in the East has begun, funded by the unified federal government.[46] Its priorities include discovery and cleanup of waste dump sites, major cleanup or restoration of sewage treatment plants and sewer lines, modernization of lignite-burning power and heating plants, and modernization of air pollution control equipment in 6,735 installations.[47]

### *Macroeconomic Stability*

The FRG has one of the better records in this area in the market capitalist world, sharing the best postwar inflation record with Switzerland. Its unemployment has gone up and down. It has avoided the double digit range throughout the postwar era and actually got its unemployment rate below 1 percent during the early 1960s, although it has gone up substantially since then.

But strict control over investment and prices by the central planners in the GDR gave it a superior record in these areas, with almost zero inflation until recently[48] and unemployment rates consistently below 1 percent throughout. As of January 1990 the unemployment rate in the GDR was 0.1 percent. By early 1992 one out of three East German workers had lost their jobs.

### *Distribution of Income and the Social Safety Net*

The distribution of income was more equal in the GDR than in the FRG, although the gap narrowed over time. Thus in 1970 the top and bottom quintile shares of income were 31.1/9.7 in the GDR and 39.9/8.3 in the FRG, whereas in 1983 they were 30.2/10.9 in the GDR and 34.3/9.8 in the FRG, respectively.[49] These figures overstate the degree of actual equality in the GDR because they do not take into account special favors and goods available to the top ruling elite, which were scandalously substantial.

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[44]Streibel, "Environmental Protection," p. 185.

[45]Streibel, "Environmental Protection," p. 202.

[46]In this regard eastern Germany is lucky because in other East European countries economic difficulties have forced environmental cleanup to take a back seat, despite the prominent role played by environmentalists in the reform movements.

[47]Klaus Zimmermann, "Ecological Transformation in Eastern Germany," in *The Economics of German Unification*, pp. 218–19.

[48]This does not account for the black market, where there certainly was inflation, nor does it account for time spent standing in line for goods, which could be several hours per day.

[49]Schnitzer, *Comparative Economic Systems*, p. 227.

Social safety net policies were surprisingly similar, both having ultimately derived from the old Bismarckian programs. Nevertheless differences can be noted. One was that administration in the East was centralized, there being no Länder. Individuals did not make payroll contributions for health care funds and health care coverage was wider, although the quality was lower and dropping. Doctors were state employees in the East but private in the West, resulting in those in the East leaving for higher incomes in the West. Social security pensions were higher in the West than in the East, an average of 1,018 marks per month versus 427 respectively,[50] one area where Ossis are gaining from unification.

The East was substantially more generous than the West in providing day care. Day care facilities were heavily subsidized in the East and barely subsidized at all in the West, a fact showing up in the relative prices for day care in Table 9–3. This correlated with substantial differences in employment of married women with children in the two states. In 1988 62 percent of married women aged 18–40 with children aged 1–6 worked in the East whereas only 28 percent worked in the West. For married women aged 25–65 with school-aged children aged 7–18, 88 percent worked in the East whereas only 32 percent worked in the West.[51] As the western system has been imposed on the East, women have been more likely to become unemployed than men. Along with increased restrictions on abortion availability, female unemployment has caused anger in the East among women.

# The Costs and Prospects of Unification

### *The Process of Unification and Its General Prospects*

The process of unification was modeled on what was done in the West in 1948. The results have been dissimilar so far, but the long-run outcome remains uncertain. Unification began with the fall of the Berlin Wall on November 9, 1989,[52] a date many identify as the effective beginning of the end of the Cold War.[53] In March 1990, elections were held in the East and Chancellor Kohl's

[50]Sinn, "Macroeconomic Aspects of German Unification," p. 121.

[51]Landua, "Social Aspects," p. 98.

[52]An unfortunate coincidence is that this was the 51st anniversary of Kristallnacht, a night when fanatic Nazis attacked stores and homes owned by Jews, smashing glass and crystal particularly, and attacking Jews themselves, an outburst heralding an upward ratcheting of the Nazi anti-Jewish campaign.

[53]Soviet leader, Mikhail Gorbachev, played a crucial role in the fall of the Berlin Wall because he signaled an unwillingness to use force to keep the Wall up. He had been unhappy with the hardline GDR leadership. Prior to the fall of the Wall, there had been a surge of East Germans emigrating through Hungary after it opened its border with Austria, a border since closed by the Austrians.

Christian Democrats won a decisive victory, promising rapid and painless absorption into the FRG under its existing constitution. On July 1, 1990, the currencies were unified at a one-to-one rate, although at a schedule of lower rates for Ostmark balances above certain levels, and most price and trade restrictions were removed. On October 3, 1990, came full legal and political unification. On January 1, 1991, the West German tax system was applied in the East.

This was the most rapid of all Big Bang economic transformations of a formerly command socialist economy into a market capitalist economy. It exhibits some of the costs and benefits of such an approach, although some of both probably apply strictly to this case alone. Mostly the costs have been visible. But with an apparent bottoming-out of output in the East and the reappearance of growth there in 1994, the light at the end of the tunnel is visible.

Although some of the aspects facing the former GDR are common to all economies attempting to transform from command socialist to market capitalist, two stick out relative to others, one positive and one negative. The positive is that being absorbed into the existing political, legal, and regulatory framework of the FRG has resolved the institutional problem—the GDR inherits a pre-existing and generally successful set of laws and property rules, functioning stock and bond markets and banking system, and a largely stable and moderate democratic political framework. These factors lead many observers to be extremely optimistic about the area's future prospects.

Furthermore, the former GDR also inherits the credibility of the West German macroeconomic managers, notably the redoubtable Bundesbank and its well-earned anti-inflation reputation. Unfortunately one of the costs of unification has been damage to that credibility due to the difficulties arising from the unification itself, especially the apparent failure of the FRG leadership, particularly Chancellor Kohl, to anticipate the scale of potential problems.[54] The Bundesbank may have so aggressively raised interest rates as budget deficits swelled from 1990 through 1992 because it was concerned about losing that hard-won credibility, although foreign critics charged the Bundesbank with overdoing it.

The great negative of the economic unification was the one-to-one currency unification, now known to constitute a wild overvaluation of the Ostmark (the former GDR currency). Combined with a drive for nominal wage equality between East and West, despite lower productivity in the East, overvaluation significantly contributed to the depth of the collapse of output in the East, which was the source of the unexpected costs triggering budget deficits that raised interest rates.

[54]Kohl and the Bundesbank split on this point—the latter opposed the one-to-one currency unification on grounds that have since been confirmed, namely an anticipated collapse of output in the East.

In contrast, Poland, which has also followed Big Bang policies, had a smaller decline in output probably because it allowed a devaluation of the Polish currency (złoty) when it decontrolled prices. Given the political unwillingness in Germany to undo this, pessimists predict that this overvaluation will be a long-run drag on the former GDR economy, discouraging future investment, permanently draining it of its most skilled workers who will move west, and creating a permanently depressed regional economy such as one finds in southern Italy or northern Britain, even though the German economy as a whole may do reasonably well. This scenario is probably exaggerated, although as of 1995 most investment in the East has been concentrated in major cities such as Dresden and Leipzig, with other areas very depressed. Over time the western part will outweigh the eastern part, with a population in 1989 four times as great and an aggregate GDP 10 times as great.

## The Output Collapse in the East

The output collapse in the East was one of the most dramatic ever seen. Taking average real 1989 GDP as an index of 100, the index stood at 54 in the second quarter of 1991.[55] In a single year, September 1989 to September 1990, net manufacturing output fell 51.1 percent.[56]

The proximate cause of this collapse was a price-cost squeeze facing firms, driving them to bankruptcy or to output reductions and layoffs. There were six underlying causes, three on the cost (supply) side and three on the price (demand) side.

Most important on the cost side were excessive wages in the East arising from the one-to-one currency unification rate[57] and the drive for equality of nominal wages with the West without equality of productivity.[58] Some western Germans claim that contributing to labor productivity shortfalls is an alleged laziness of eastern workers relative to western ones. If this is true, it reflects 45 years of a "we pretend to work and they pretend to pay us" mentality. Such charges by Wessis aggravate the increasingly bad relations between them and the Ossis.

A second factor was technologically outmoded capital stock, which raised costs directly and implied future higher costs for retooling. The third

[55] *1991/1992 OECD Economic Surveys: Germany* (Paris: Organization for Economic Cooperation and Development, 1992), p. 20.

[56] Rolf Hasse, "German-German Monetary Union: Main Options, Costs and Repercussions," in *The Economics of German Unification*, p. 44.

[57] An oddity of the currency unification that damaged existing small private enterprises in the East was that liquid assets were only exchanged at a two-to-one rate whereas debts were exchanged at a one-to-one rate.

[58] It may be that the rate of currency unification was irrelevant and that it was the demand for nominal wage equality that was the problem. It may have been better to impose increased wages at once through the currency rate rather than letting the increase drag on through disruptive strikes with the accompanying uncertainty and social and political disruption.

such cost was the heavy pollution produced by much of the eastern productive plant—no private party wanted to be held responsible for cleanup. The government has assumed responsibility in this area.

The immediate source of the collapse of internal demand resulted from the sudden availability of western goods at reasonably low prices,[59] also a result of the overvaluation of the Ostmark at currency unification. Important factors in the collapse of demand were both sheer novelty and fundamental quality. The first factor was overdone and somewhat temporary with a nostalgic return to eastern goods in certain markets later. But the quality issue was very real and decisive in many areas, such as in ending production of the East German Trabant car.

The second round of the demand collapse was the negative multiplier effect of the first one. The initial decline in demand triggered a series of layoffs and income declines that further suppressed demand, although this second collapse has been mitigated by infusions of assistance from the West.

The third source of demand decline came from the general collapse of the CMEA and the loss of former markets in Eastern Europe by the former GDR. Some of the shining stars of the former GDR economy had been high-technology goods it supplied to the rest of the CMEA, such as optical equipment and microchips. To the extent that the former buyers can still buy, they now have available other producers such as the Japanese who offer higher quality at lower prices. But beyond that these economies have all suffered output declines and have reduced all imports.

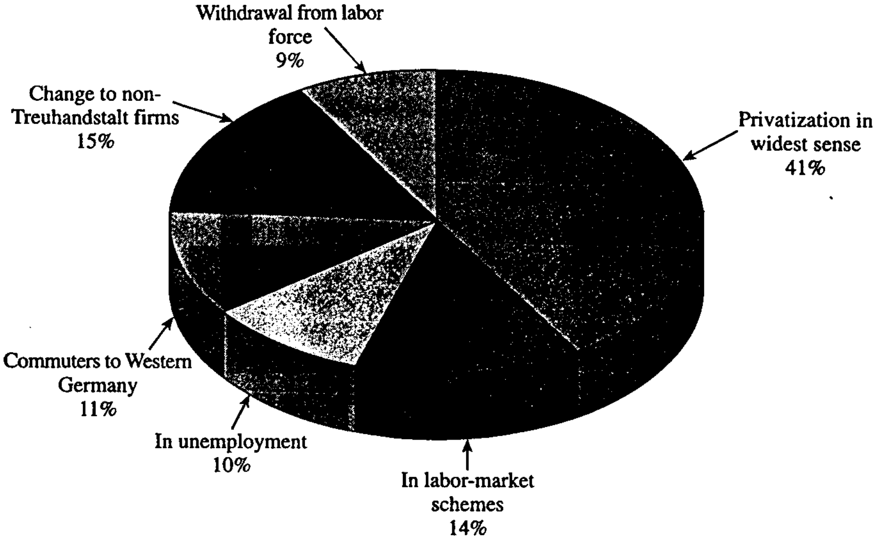
## *The Rise of Unemployment in the East*

The output collapse caused a surge of unemployment, with the figure of one out of three workers losing their jobs widely reported. However the official unemployment rate was only 16.5 percent in January 1992. What happened to the other half of the laid-off workers? Some retired early, some (especially women who lost their inexpensive day care) dropped out of the labor force, some became "short time" workers, some went into retraining programs, some migrated to the West or are commuting there for work, and some have found other employment in the East.

A rough measure of this pattern is given in Figure 9–1. Of 4.1 million workers in state firms at the end of 1989, 2.4 million had been removed from that category at the end of 1991 by the *Treuhandstalt* privatization agency. Figure 9–1 shows what those 2.4 million workers were doing. These percentages continued to hold through the end of the Treuhandstalt's activities by the end of 1994.

[59]Some of this collapse of demand stimulated the West German economy as it sold goods to the East, and output expanded in the West as it contracted in the East until the end of 1992 when the West went into recession as well. But the surge of imports to the East caused the overall current account balance to go into a rare deficit, thus triggering borrowing from abroad and adding to the pressure for higher interest rates.

**FIGURE 9–1a Labor Adjustments in Treuhandstalt Firms**




Source: From 1991–1992 *OECD Economic Surveys: Germany* (Paris: Organization for Economic Cooperation and Development, 1992), p. 53.

## *The Privatization Process*

For transforming economies it is easier to reintroduce the market than it is to reintroduce capitalism because a rudimentary market can be introduced by eliminating central planning and decontrolling prices, something accomplished to varying degrees in most of Eastern Europe despite some institutional and legal complexities. But to fully reintroduce capitalism means to privatize the existing set of state-owned assets, which is a complicated and controversial process.

Some countries, notably the Czech Republic and Russia, have rapidly privatized using vouchers to distribute state-owned assets to the population. Others have attempted more gradualistic approaches, usually involving selling an asset to a nonvouchered buyer with some financial capital in the hope that the buyer will make some capital investment for retooling or whatever. Proponents of this gradual approach hope that private ownership in turn will provide a more solid foundation for the future economy. Germany took the gradual approach, although it moved as rapidly as possible within its chosen framework.

The German approach involved establishing the above-mentioned Treuhandstalt agency (THA) to dispose of state-owned firms. The THA established a committee for each firm to be privatized that searched for a core business that could be saved. Rarely did the THA try to sell an entire firm, especially if it was a former Kombinate and thus rather large. Rather firms were usually broken up into pieces that were then sold off by whatever mechanism could be agreed upon.[60]

As of the end of March 1992, 42 percent of THA firms remained to be privatized, 30 percent had been sold to Germans (overwhelmingly from the West), 10 percent had been liquidated (mostly firms that sold goods to dead former CMEA markets such as military goods), 7 percent had been sold to foreigners, 6 percent had been reprivatized (returned to a previous owner or their heirs), and 5 percent had been transferred to municipalities.[61] The disposition of THA firms since then involved a higher rate of liquidations because the firms involved were among the least productive and hardest to sell of all the firms. The THA formally ceased to exist at the end of 1994.

Reprivatizations have caused serious complications. In many cases assets are tied up in disputes over ownership among previous owners, especially over real estate. These disputes now clog the courts and will take years to sort out. The situation is especially complicated because former owners have been granted fairly generous rights and also because several waves of property confiscations led to multiple past ownerships. Jewish-owned properties were seized by Nazis and Nazi-owned properties were redistributed to other individuals after the war but before they were nationalized. As many as 15 different parties are contesting ownership of a single asset.

## The Budget Deficit

Chancellor Kohl and his advisers did not expect a budget deficit because they forecast a 1948-style Wirtschaftswunder with quickly soaring output. When the opposite happened government spending soared to cover unemployment compensation, higher old age pensions, environmental cleanup, and loans to the THA. A Unity Fund was established to finance these activities, which quickly grew to over 30 billion deutsche marks. Borrowing by the THA has been on a similar scale. From a surplus of 0.2 percent of GDP in 1989, the budget went into a 3 percent of GDP deficit as of 1992, 4 percent if THA borrowing is included.[62]

This problem is gradually improving as expenditures by the Unity Fund decline and by the THA have ceased. Also the Kohl government belatedly enacted some tax increases and spending cuts in social welfare areas.

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[60]In some cases the sale price was *negative* after grants, debt cancellations, unemployment payments, environmental cleanup costs, and other payments were counted (OECD, *Economic Surveys*, p. 52).

[61]*OECD Economic Surveys*, pp. 51–54.

[62]*OECD Economic Surveys*, p. 39.

**Box 9–2**

## The "Colonization of East Germany"?

A subtle problem, but perhaps the most dangerous for the long-run prospects for national unity, is the increasingly aggrieved feeling that exists in the East of having been "colonized" by the West.* Given the scale of the unemployment increases, the increased child care burdens on women and restrictions on abortion, and the decline in income, this feeling is understandable. Also now many employers are Wessis; the Wessis are on top and they are on the bottom. Of course the Wessis have their own complaints: that the Ossis are lazy, that the unification is costing too much in taxes, that social spending has been cut back, and that interest rates are higher.

A noneconomic component of this perception is the purge of various institutions in the East. Anyone who was a member of the former ruling Socialist Unity Party or who worked with the Stasi secret police has been automatically fired from any public position. Whole categories of civil servants were fired, including the entire judiciary and whole university departments. A general "political correctness" investigation goes on in the East that is both adding to unemployment and exacerbating Ossi resentments. Many of those who have fallen victim to this campaign include people who were dissidents against the GDR régime and aided in its overthrow. Now they have become dissidents once again.†

The new unity of Germany will probably hold, simply because the West profoundly dominates the East. But if that is the only reason it does so, then it will be an unstable unity, a development Germany's neighbors fear.

*See Dorothy Rosenberg, "The Colonization of East Germany," *Monthly Review* 43 (September 1991), pp. 14–33.

†The murkiness of all this is seen in the charges that he was a Stasi informer leveled against 81-year old novelist and former dissident, Stefan Heym, when he entered the Reichstag as a member of the post-communist Party of Democratic Socialism in late 1994.

## A "European Germany or a German Europe"?

The unification of Germany generates pressures both towards European unification and away from it. A major pressure for unification comes from fear. Although former President Mitterand of France supported German unification against British doubts, he did so recognizing its inevitability and hoping to keep the outcome under control. This meant pushing through the Maastricht Treaty and pushing the full unification of Europe to rope Germany in and keep it under the control of the higher European entity, thus ensuring a "European Germany."

The Maastricht Treaty was signed in December 1991 and has been approved by all EU member states. But complications have arisen, most importantly involving currencies. At Maastricht, Germany demanded and got major concessions. Not only will the future European central bank be located in Frankfurt where the Bundesbank is, but also any country joining the common currency must meet a stringent set of macroeconomic criteria regarding budget deficits, inflation rates, and so forth, so stringent that as of early 1995 the only EU member eligible to join was Luxemburg. Under current arrangements, Germany and the deutsche mark dominate the EU and the other currencies in an asymmetric relationship, and Germany is reluctant to give that up.

Another major issue is Eastern Europe. Absorbing the former GDR automatically increased Germany's involvement there. Germany had to pay Russia to allow for the unification. It has become Russia's largest creditor, thereby dragging Germany into the complex problems arising from the dissolution of the FSU and the ongoing struggles there over reform.

Also, before World War II Germany had extensive trade relations with the nations to the East, relations artificially disrupted by the division of Europe in the Cold War. Now Germany seeks to revive those trade relations and has been ahead of all other countries outside of Eastern Europe in expanding trade and investment there. As a result, Germany has become the champion of those countries that seek to join the EU, although not of the former republics of the USSR, except for the Baltic ones.[63]

Germany's relationships with Eastern Europe create conflict with France and other EU members not wishing to expand the EU eastward. They would rather intensify the drive to unity among existing members. An underlying fear is that Germany is not just after economic gains, but may be reviving its ancient drive for political domination of the East as well, despite having renounced its claims on territories lost in World War II. Will the emergence of German unity once again lead it to seek to establish a universal empire, however subtly?

A German response is that bringing Eastern European nations into the EU will further dilute its own role as the EU gets bigger. Furthermore, Germany is driven by its own fears, particularly that immigration from these countries might increase if their economies are not developed. It is anti-immigrant sentiment that drives the most extreme neo-Nazi activists in Germany. Germany's opening to the East is an effort to protect both itself and its neighbors from its own historical demons.

[63]A further subdivision appeared in a 1994 German study advocating "tiers" within the EU, with an "inner core" of Germany, France, the Netherlands, Belgium, and Luxemburg possessing a unified currency. It sees Poland, the Czech Republic, Slovakia, Hungary, and Slovenia as being ready for EU membership sooner than other East European states. This study, disavowed by the German government, created great controversy.

The unification of Germany means it will be the leader of Europe. Thus the fate of the German economy will determine the fate of the European economy. Will there be a German-led, Europeanwide Wirtschaftswunder, or will "Eurosclerosis" take over and drag all down into ethnic and nationalistic conflict?

Whether Germany can match the competition in high technology from Japan and the United States may be important in deciding that question. The signs are troubling for Europe on the high-technology front. Although Germany maintains a level of R&D spending equal to that of Japan and the United States in percent of GDP, its slow GDP growth means that absolute R&D spending has not grown rapidly. Germany maintains a strong position in machine tool and automotive technologies (Siemens and Daimler-Benz were first and second in European R&D spending in 1989), but it has fallen to second behind the United States in biotechnology and is a distant third in computers and information technologies, areas likely to be critical in the future.[64]

An important reason Germany has failed to keep up in R&D has been weak support by the federal government for such expenditures. A deeply entrenched factor is abdication to the Länder of much responsibility for such financing and for encouraging economic development more broadly. Although granting power to the Länder solves the problem of reconciling the separatist tendencies of the German tribes with the existence of a unified nation-state, the inability to grant greater powers to the central German government could doom the entire European enterprise to another German-centered disaster.

## Summary and Conclusions

Germany has long struggled to achieve national unity out of diverse elements among its peoples. The struggle for unity has been complicated by uncertainty as to who were its peoples and where were the appropriate boundaries of their domains. Although Germany achieved moments of great unity under the inspiration of universal empires, it has also experienced catastrophes of national disintegration and economic collapse as in the Thirty Years War and at the end of World War II. But the German people always rise again, as they are doing with the unification of East and West Germany.

Germany's economic strength has depended upon the skills, genius for creation, and hard work of its people. A center of advanced education and scientific achievement, the German economy has long been a technological leader of the world economy. As the fourth largest economy in the world, it competes at the high end of technology with the two largest economies, the United States and Japan.

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[64]Smyser, *The Economy of United Germany*, pp. 108–110.

Germany's industrialization in the late 19th century was very rapid. Although Germany's unifier in 1871, Chancellor Bismarck, ruled despotically, he introduced the first government-funded social security, health insurance, and workmen's compensation systems in the world. This established the tradition known after World War II as the social market economy, a system characterized by market capitalism with an extensive social safety net. This system has been imitated by many nations since.

During the Great Depression the Nazi dictator, Adolf Hitler, established a command capitalist economy. It grew successfully at first, but then Hitler started World War II, which led to a total economic collapse as well as military and political defeat. Germany was divided into East and West by the victorious allies. The East became part of the Soviet bloc and a command socialist economy was established. In the West a social market economy was established, and an economic miracle of rapid growth appeared after price and currency reforms in 1948. West Germany's economy has also been characterized by labor-management co-determination and substantial bank ownership and control of major corporations.

Over the postwar era, the West German economy integrated into the wider European economy through the institution of the European Union. Eventually its success led it to reabsorb what had been independent East Germany in 1990. The process of unification has been more difficult and costly than expected, with consequences complicating further European unification. The great drama today of Germany is first, whether or not it can successfully complete its unification and second, whether or not it can return to leading Europe towards a peaceful and productive balance of unity and diversity on a path to a sustainable and fulfilling future.

## Questions for Discussion

1. What is the source of the "German Problem" in Europe and how does it affect prospects for European unification?
2. Compare and contrast Hitler's command economy with that of the former East Germany.
3. Compare and contrast the 1948 West German reform policies with those applied in 1990 in eastern Germany during unification with the FRG.
4. What elements of the German economy resemble those of Japan's?
5. Compare and contrast German labor market policies with those of Sweden.
6. How does the German economic system compare with that of the United States?
7. Compare the social safety nets of the former East and West Germanies.

8. Evaluate the claim that West Germany has "colonized" the former East Germany.
9. Why has the unification of Germany cost more than expected and what are the implications of this fact?
10. Explain and evaluate the claim that Germany is a "fading miracle."

## Suggested Further Readings

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